



ORIGINAL

BEFORE THE ARIZONA CORPORATION COMMISSION

2 MIKE GLEASON
CHAIRMAN
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AT THE ARIZONA CORPORATION COMMISSION
DOCKET CONTROL

Arizona Corporation Commission
DOCKETED

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8 IN THE MATTER OF THE APPLICATION OF
9 ARIZONA-AMERICAN WATER COMPANY,
10 AN ARIZONA CORPORATION, FOR A
11 DETERMINATION OF THE CURRENT FAIR
12 VALUE OF ITS UTILITY PLANT AND
PROPERTY AND FOR INCREASES IN ITS
RATES AND CHARGES BASED THEREON
FOR UTILITY SERVICE BY ITS SUN CITY
WATER DISTRICT.

Docket No. W-01303A-07-0209

13
14 **RUCO'S CLOSING BRIEF**

15 **INTRODUCTION**

16 The Residential Utility Consumer Office ("RUCO") submits this Brief in response to
17 Arizona American Water Company's ("Arizona American" or "Company") request that the
18 Arizona Corporation Commission ("Commission") authorize a rate increase of \$1,806,508
19 for the Company's Sun City Water District. While there are several issues in dispute that
20 will be addressed in this Brief, RUCO's primary contention is that the Commission should
21 reject the joint proposal of Staff, the Company and the Town of Youngtown ("Youngtown"
22 or the "Town") to approve a fire flow cost recovery mechanism ("FCRM") to recover the
23 costs associated with the fire flow projects being proposed in this case. These
24 discretionary expenditures, which concern fire flow improvements and will total an

1 estimated \$5.1 million, will have the effect of raising rates an estimated 10 percent beyond
2 the rates approved in this case. The Company is seeking a rate increase of 26.16 percent
3 in this cases (in addition to a 33.1 percent increase in the Company's pending Sun City
4 Wastewater application. See Final Sun City Wastewater Schedule A-1 of Cheryl Hubbard
5 in Docket No. WS-01303A-06-0491.) In this time of soaring utility rates in every sector
6 this Commission regulates, it is unwise to set a precedent allowing utilities to ratebase
7 discretionary expenditures which have a negative effect on rates. Ratepayers should not
8 fund the improvements – instead, the entity requesting the discretionary projects should
9 fund the improvements.

11 **FIRE FLOW SURCHARGE**

12 **1) THE COMMISSION SHOULD REJECT THE JOINT PROPOSAL OF STAFF, THE** 13 **COMPANY AND THE TOWN TO INCLUDE IN RATEBASE DISCRETIONARY** **FIRE FLOW IMPROVEMENTS.**

14 The Arizona Constitution charges the Commission with setting reasonable rates.
15 Arizona Constitution article XV, § 3. Arizona Administrative Code ("A.A.C.") R14-2-407 (E)
16 requires a minimum standard delivery pressure of 20 pounds per square inch gauged at
17 the customer's meter or point of delivery. There is no other Commission Rule, policy or
18 statute that governs or sets a fire flow standard. There is no regulatory rate making
19 principle that requires or even supports a fire flow standard. As the Company willingly
20 admits, the proposed \$5.1 million in fire flow improvements is a discretionary expenditure.

21 A-3 at 8.¹

24 ¹ For ease of reference, trial exhibits will be identified similar to their identification in the Transcript of Proceedings. The Transcript volume number and page number will identify references to the Transcript.

1 Typically, as the Company also admits, when a third party² requests the
2 construction of additional water infrastructure from a regulated utility, the Commission
3 requires an Advance in Aid of Construction or a Contribution in Aid of Construction. This
4 rate treatment is especially appropriate when the cost of the expenditures outweighs the
5 expected revenue from the project. Here, the discretionary expenditures will significantly
6 increase the ratebase and will not produce any incremental revenue. R-10 at 9. The
7 balance is weighted against rate basing the improvements in this case given the fact that
8 the discretionary fire flow expenditures are non-revenue producing and will result in a
9 minimum ten percent rate increase. The Commission should not approve the fire flow
10 improvements.

11 In addition, there is no other Arizona-American affiliate in any other state required
12 or mandated by a state regulatory commission to "undertake specific improvements in fire
13 flows in an existing community³." A-14 at 1. The Commission specifically said it was not
14 setting a precedent when it approved the fire flow improvement project in the Paradise
15 Valley case, and should not set the precedent here. Decision No. 68858 at 12.

16 **A) THE FACT THAT RATEPAYERS WOULD BENEFIT FROM FIRE FLOW**
17 **IMPROVEMENTS IS NOT SUFFICIENT JUSTIFICATION FOR THE**
18 **COMMISSION TO ALLOW RECOVERY OF THE DISCRETIONARY**
19 **COSTS OF THE FIRE FLOW PROJECTS.**

20 There appears to be two reasons why Staff, the Company and the Town are
21 recommending a surcharge mechanism to recover the discretionary fire flow expenditures.
22 First, ratepayers would benefit because the discretionary improvements are what
23 ratepayers allegedly want and the community allegedly needs, and second, the projects

24 ² The Company admits with regard to a developer. Transcript at 138.

³ Other than what is required by statutes or rules. Id.

1 will improve public fire safety in the Sun City Water District. RUCO does not take issue
2 with either reason, but both reasons miss the point. The point is not the benefit or what the
3 community needs but who is going to pay for the benefit.

4 It is laudable that a portion of the Sun City District ("District") wants to improve their
5 public fire safety conditions. RUCO would never stand in the way or suggest that the
6 Commission stand in the way of such an admirable goal. However, it should be the party
7 that is requesting the benefit, the Town - not the water utility's customers that pay for the
8 improvements. Ratepayers would enjoy the same benefits if the Town paid for the
9 improvements.

10 Moreover, should the Commission consider the benefits to ratepayers; it should
11 consider the cumulative effects on all of the ratepayers in Arizona, and not just the
12 ratepayers that are served by the Company in the Sun City District. The Company has
13 been engaged in discussions with representatives from other Arizona communities
14 regarding fire flow improvements. A-3 at 9. In the Paradise Valley Decision the
15 Commission sanctioned fire flow improvements, and it is clear that this Company intends
16 to use Paradise Valley as precedent and seek recovery for fire flow projects in its other
17 Arizona Districts. The Commission should not burden ratepayers with discretionary
18 investment that could in the long run jeopardize the affordability of water service in
19 Arizona.

20 **B) THERE IS NO LEGAL IMPEDIMENT PREVENTING THE TOWN OR SUN**
21 **CITY FROM FUNDING THE FIRE FLOW IMPROVEMENTS.**

22 The Town is requesting the discretionary fire flow improvements, but the Town does
23 not want to pay for them. In terms of the whole district, of those surveyed 59 percent of
24 the District supported the fire flow improvements and 51 percent are willing to pay for it. A-

1 5 at 1. The Town claims that Gift Clause of the Arizona Constitution ("the Gift Clause")
2 prohibits it from funding the fire flow improvements. Transcript at 279, 284. The Gift
3 Clause of the Arizona Constitution and Arizona Revised Statute ("A.R.S.") § 9-514 are
4 often cited by municipalities as the legal basis preventing the municipality from spending
5 public monies to build infrastructure that would be owned by the private Company. See for
6 example, Decision No. 68858 (Paradise Valley) at 8, *Town of Gila Bend v. Walled Lake*
7 *Door Company*, 107 Ariz. 545, 490 P.2d 551 (1971). The Town's reliance on A.R.S. § 9-
8 514 and/or the Gift Clause is misplaced – there is no legal impediment preventing the
9 Town or Sun City through its Recreation Center or otherwise from funding the
10 improvements.

11 A.R.S. § 9-514 provides in relevant part:

12 A. Before construction, purchase, acquisition or lease by a municipal
13 corporation, as authorized in §§ 9-511, 9-511.01, 9-511.02, 9-512 and 9-513, of any
14 plant or property or portion of property devoted to the business of or services
15 rendered by a public utility shall be undertaken, the construction, purchase,
16 acquisition or lease shall be authorized by the affirmative vote of a majority of the
qualified electors who are taxpayers of the municipal corporation voting at a general
or special municipal election duly called and held for the purpose of voting upon the
question.

17 Article 9, § 7 of the Arizona Constitution - the "Gift Clause" - provide:

18 Section 7. Neither the state, nor the county, city, town, municipality, or other
19 subdivision of the state shall ever give or loan its credit in the aid of, or make any
20 donation or grant, by subsidy or otherwise, to any individual, association, or
21 corporation, or become a subscriber to, or a shareholder in, any company or
corporation, except as to such ownerships as may accrue to the state by operation
or provision of law or as authorized by law solely for investment of the monies in the
various funds of the state.

22 The Town is not the first municipality to claim A.R.S. § 9-514 and the Gift Clause
23 prohibit a local municipality from paying for a water main that would provide adequate fire
24 protection. In the *Town of Gila Bend v. Walled Lake Door Company*, 107 Ariz. 545, 490

1 P.2d 551 (1971), the Town of Gila Bend ("Gila Bend"), relying on A.R.S. § 9-514 and the
2 Gift Clause, argued that it was not legally responsible to build and pay for a water main
3 that was to benefit a single customer, Walled Lake Door Company ("Walled Lake"),
4 pursuant to a contract that Walled Lake and Gila Bend entered into. Specifically, Walled
5 Lake owned a plant in Gila Bend that was destroyed by fire. *Id.* at 547, 553. In order to
6 reconstruct the damaged plant, Walled Lake needed assurances from Gila Bend that it
7 would provide Walled Lake with adequate fire protection. *Id.* Gila Bend agreed and the
8 two parties entered into an agreement whereby Gila Bend would build the necessary water
9 main to provide adequate fire protection in exchange for Walled Lake's agreement to
10 reconstruct the fire damaged plant. *Id.* Walled Lake carried out its part of the bargain but
11 Gila Bend failed to honor its part of the bargain, claiming ARS §9-514 and the Gift Clause
12 prohibited it from performing. *Id.* at 548, 554.

13 The Arizona Supreme Court, rejecting Gila Bend's argument, held that A.R.S. § 9-
14 514 (through 9-516) deals with the power of municipalities to engage in *competition* with
15 businesses of a public nature. While these provisions would have been applicable had
16 Gila Bend sought to enter into competition with the existing water utility, such was not the
17 case and the Court rejected the argument. In the subject case, like *Gila Bend*, there is no
18 issue of the Town competing with the Company to provide water utility service. Neither the
19 Town nor Sun City has indicated that they intend to build separate infrastructure or
20 compete with the Company in any way. The Commission should reject the argument that
21 the Gift Clause and/or A.R.S. § 9-514 prevents the Town from funding the improvements
22 that the Town is requesting.

23 Moreover, the plain language of the statute itself is clearly inapplicable to the
24 present situation. A.R.S. § 9-514 concerns the construction, purchase, acquisition or lease

1 of plant or property by a municipal corporation – none of which the Town or Sun City is
2 requesting or contemplating. The Town and Sun City are requesting that the Company
3 make the improvements – neither the Town nor Sun City are making the improvements, or
4 purchasing, acquiring or leasing the Company's plant. When a statute's language is clear,
5 the Courts in Arizona will not look beyond the statutes plain language to determine its
6 meaning. *Hayes v. Continental Ins. Co.*, 178 Ariz. 264, 872 P.2d 668 (1994); *City of Casa*
7 *Grande v. Arizona Water Company*, 199 Ariz. 547, 554, 20 P. 3d 590, 597 (App. 2001).
8 The Town and Sun City are not prohibited by the Gift Clause and/or A.R.S. § 9-514 from
9 funding the discretionary fire flow improvements.

10 The Supreme Court further dismissed Gila Bend's argument that the Gift Clause
11 prohibited Gila Bend from constructing the water main. Gila Bend's ill-fated argument was
12 that construction of the main would benefit only Walled Lake and therefore would violate
13 the Gift Clause. *Town of Gila Bend* at 549, 490 P.2d 555. The Supreme Court noted that
14 the evil sought to be avoided by the Gift Clause is the "depletion of the public treasury or
15 inflation of public debt by engagement in non-public enterprise." *Id.*, see also *State v.*
16 *Northwestern Mutual Insurance Company*, 86 Ariz. 50 at 53, 340 P.2d. 200 at 201 (1959).
17 Public funds are to be spent only for "public purposes" and not to "foster or promote the
18 purely private or personal interests of any individual." *Town of Gila Bend*, *supra*, see also
19 *Proctor v. Hunt*, 43 Ariz. 198, 29 P.2d 1058 (1934). The Court noted that each case is
20 different and that each case must focus on the objective sought and the degree and
21 manner in which that objective affects the public welfare. *Town of Gila Bend*, *supra*, see
22 also *City of Glendale v. White*, 67 Ariz. 231 at 237, 194 P. 2d. 435 at 439 (1948).

23 In reaching its conclusion, the Court opined that the fact Walled Lake would benefit
24 both directly and indirectly should a fire occur is of "absolutely no consequence." *Town of*

1 *Gila Bend* at 549-550, 490 P.2d 551, 555-556. Merely because a company may benefit
2 from a public expenditure does not make that expenditure illegal. *Id.* The Court concluded
3 that the Gift Clause does not apply because there is no doubt that supplying of water for
4 purposes of preserving and protecting lives is a "public purpose" and one which will directly
5 provide a direct benefit to the public at large.

6 The Supreme Court's reasoning squarely addresses the Town's position in the
7 present case. Staff, the Company and the Town have focused their arguments on the
8 "public purpose" nature of fire protection as the basis for their recommendation to recover
9 the costs of the discretionary fire flow improvements. RUCO agrees that the
10 improvements will serve a public purpose and the public will benefit. The Town is not
11 prohibited by the Gift Clause from paying for the fire flow improvements.

12 **C) THE TOWN AND SUN CITY SHOULD FUND THE FIRE FLOW**
13 **IMPROVEMENTS. THE COMMISSION SHOULD NOT FORCE THE**
14 **COMPANY TO MAKE THE IMPROVEMENTS IF THE COMPANY WILL**
NOT MAKE THEM VOLUNTARILY.

15 The Town argues that it does not have the financial means to make the
16 improvements. Y-4 at 9. RUCO is sympathetic to the Town's financial situation.
17 However, the Town's ability to finance the fire flow improvements in no way lessens its
18 responsibility and obligation to address the responsibilities it is charged with. The Town,
19 not the Commission are responsible for establishing, funding and enforcing fire flow
20 standards and improvements.

21 It has been suggested that the Commission has the power under Article 15, Section
22 3 of the Arizona Constitution to order the improvements. RUCO does not take issue with
23 that interpretation - RUCO agrees that it is within the Commission's discretion to order the
24 improvements. That does not mean, however, that the Commission **should** order the

1 improvements. Again, the Commission is not in the business of setting and enforcing fire
2 flow standards. This is something that is typically left to the municipality. The only
3 applicable Commission standard here is the 20 psi standard with which the Company is in
4 full compliance.

5 The Company recognizes that a Commission order requiring the Company to make
6 the fire flow improvements sets a bad precedent. A-4 at 12. According to the Company,
7 such an order "... might encourage local officials in the future to be less focused on fiscal
8 realities and more focused on just getting the Commission to require its jurisdictional
9 utilities to fund the construction of discretionary projects." Id. RUCO shares in the
10 Company's concerns.

11 Moreover, the Company has made it clear that the only way it will voluntarily make
12 the improvements is if the Commission approves the FCRM. The Company will not agree
13 to make the investment in exchange for a deferral order to allow later recovery of the
14 costs. Transcript at 1018. This position is revealing and helps explain the Company's true
15 profit oriented motive. Throughout the proceeding, the Company as well as the Town have
16 complained about the dire conditions of the system and the need to improve the system to
17 handle the District's fire flow needs. Given the dire circumstances as portrayed by the
18 Company and the Town, the length of time those circumstances have allegedly existed,
19 and the Town and Sun City's failure to address those circumstances, the Commission
20 should not now be forced to approve up-front a non-traditional method of recovery that
21 places ratepayers at a disadvantage. Coupled with the fact that only 51 percent of those
22 ratepayers surveyed would be willing to pay for the projects, the Commission should not
23 approve the FCRM.

1 **D) THE COMMISSION SHOULD CONTINUE TO APPROVE AND**
2 **DISTINGUISH CERTAIN DISCRETIONARY EXPENDITURES FOR**
3 **PROGRAMS LIKE THE LOW INCOME PROGRAM, DEMAND SIDE**
4 **MANAGEMENT AND THE RENEWABLE ENERGY PROGRAM.**

5 RUCO is not advocating that the Commission disapprove every discretionary
6 expense. RUCO has advocated and supports certain discretionary projects such as the
7 low income program proposed in this case and Demand Side Management ("DSM")
8 programs as well as renewable energy programs proposed in other cases. But these
9 discretionary programs are easily distinguishable from fire flow projects.

10 The low income program is designed to make basic water service available to those
11 people who could not otherwise afford it. RUCO believes that every person, regardless of
12 their financial condition should have access to basic water service. Basic water service is
13 one of life's necessities. Regardless of how the Commission does it, if one group of
14 ratepayers receives assistance, another group will pay more than their fair share. Cross-
15 subsidization is inevitable if all ratepayers are to receive basic water service. The low
16 income program may be discretionary and result in cross subsidization, but it is necessary
17 in order that all ratepayers receive basic water service and it is well within the scope of
18 what the Commission does on a day-to-day basis.

19 DSM and renewable energy programs are programs that are also within the scope
20 of what the Commission does on a day to day basis. DSM and renewable energy
21 programs ultimately expected to result in lower rates for the Company's ratepayers. By
22 contrast, the fire-flow projects will have a negative impact on rates (i.e. the fire-flow
23 improvements will raise rates). The Commission should reject the Company's proposal to
24 recover the costs associated with the fire-flow improvements through the FCRM.

1 **2) THE COMMISSION SHOULD REJECT THE FCRM.**

2 The FCRM is similar to the Arsenic Cost Recovery Mechanism ("ACRM") in that it
3 would allow for the recovery of costs through a series of step-surcharges⁴. R-10 at 4. It is
4 also similar in that it would afford the Company immediate cost recovery for the
5 improvements and no rate case would be necessary. Where it differs from the ACRM is
6 that the FCRM would not be limited to two steps. Id.

7 The FCRM, like the ACRM will only consider cost increases in one category of
8 expenses and will ignore changes in revenues, cost of capital, rate base and other
9 expense categories. R-11 at 4. Ratepayers will not enjoy the benefits of efficiencies or
10 other potential off-sets to costs since the sole focus of the step reviews will be the
11 incremental fire flow costs. This is "single-issue" ratemaking and as such, the Court of
12 Appeals in this state has recognized it is "fraught with potential abuse." See Scates v.
13 Arizona Corporation Commission, 118 AZ. 531, 534, 578 P.2d 612, 615 (1978). To the
14 extent the Commission is willing to consider such mechanisms, it should only do so under
15 the most dire and extreme circumstances. Approving a mechanism for the recovery of
16 discretionary projects that are not in the purview of what the Commission regulates does
17 not qualify for this extraordinary ratemaking device.

18 The ACRM was the result of a change in the federal law which did not provide water
19 companies with an alternative. No one questioned that in order to comply with the new
20 federal arsenic standard, numerous water utilities would have to expend large amounts of
21 capital in a relatively short time to build the infrastructure in addition to the operation and

22
23 ⁴ The Commission has approved an ACRM to recover the costs associated with the treatment of
24 arsenic that has resulted from the new federal standard for acceptable levels of arsenic that would impact
dozens of Arizona utilities simultaneously.

1 maintenance costs. RUCO, the Commission's Staff and the water utilities all understood
2 the unique situation confronting the water utilities because of the new law and worked hard
3 to come up with a cost recovery mechanism that was fair to ratepayers and allowed timely
4 cost recovery. While the ACRM raises the same concerns raised by the *Scates* Court, the
5 mechanism became unavoidable given the fact of change in the law and its simultaneous
6 impact on a large number of water systems.

7 Here, the parties are proposing a similar mechanism be applied to discretionary
8 projects that typically are within the purview of the municipality or, in the case of Sun City
9 (where there is no municipal government), the Sun City Recreation Center. Yet, neither
10 the Town of Youngtown nor Sun City have made any efforts to raise the funds necessary
11 to make the improvements. Transcript at 302-308.

12 The Town owned the water utility prior to selling it to the Company's predecessor in
13 1995. Transcript at 302. The system under consideration has been the same one that
14 was in place for the last fifty years. *Id.* The inadequacies the Town claims now exist also
15 existed when the Town owned the system. Transcript at 237-238, 302. RUCO does not
16 dispute that the system may be inadequate for fire flow purposes, but asserts that it is the
17 Town and Sun City that should be responsible for funding the projects.

18 The Town claims that it does not have the resources to fund the projects.
19 Transcript at 281-285. But the Town has not put a ballot before its residents to fund the
20 improvements. *Id.* at 305. The Town claims that it does not have a financial source (i.e. a
21 guaranteed stream of income) adequate enough to allow it bonding authority. *Id.* at 281-
22 282. But the Town previously owned the water utility and was collecting steady revenues.
23 The Town did not raise the revenue to address the inadequacies it claims when it did have
24 a steady revenue stream. While these arguments may be noteworthy, they are irrelevant

1 to the issue of who should fund the projects. As the case when a developer or other third
2 party seeks service, it is the third party and not the ratepayers who should pay through
3 contributions for the service. It is neither traditional nor good ratemaking to pass the costs
4 of recovery for the fire flow projects to ratepayers and the Commission should reject the
5 FCRM.

6 **RELIEF REQUESTED:** The Commission should reject the Company and Staff's
7 proposal for approval of an FCRM.

8 9 **RATE BASE ADJUSTMENTS**

10 **RATE BASE ADJUSTMENT # 3 - WORKING CAPITAL**

11 A company's cash working capital requirement represents the amount of cash the
12 company must have on hand to cover any differences in the time period between when
13 revenues are received and expenses must be paid. R-5 at 14. The most accurate way to
14 measure the cash working capital requirement is via a lead/lag study. Id. The lead/lag
15 study measures the actual lead and lag days attributable to individual revenue and
16 expense items. Id.

17 In this case, the Company did not perform a lead/lag study. Id. at 13. The Company
18 recommends a zero cash working capital allowance. Id. The Company's recommendation
19 has no in-depth data-based connection to this Company's actual cash working capital
20 needs. In fact, the Company as well as Staff have recommended a zero cash working
21 capital allowance in several recent rate applications involving water and/or wastewater
22 utilities, and the Commission has repeatedly rejected a zero cash working capital
23 allowance. (See for example, Decision Nos. 69396 and 69440). The Company's
24

1 proposed zero cash working capital allowance is not based on an objective analysis of the
2 Company's cash working capital needs.

3 RUCO's cash working capital allowance is based on an objective analysis and
4 results in a positive cash working capital allowance for Sun City. Id. at 14. RUCO relied
5 on the lead/lag study developed by the Company in its Mohave District rate application. Id.
6 at 15. RUCO's reliance on the lead/lag study developed by the Company in its Mohave
7 District rate application is appropriate here for several reasons. First, a large portion of the
8 expenses are incurred at the Company's central/corporate headquarters, and are common
9 to both the Mohave and the Sun City Districts. Id. at 15. Of the 17 different expenses
10 involved in the lead/lag study, 15 should have very minimal if any variance across Arizona-
11 American's Districts. Id. This point alone makes the lead/lag study just as applicable here
12 as in the Mohave case since it is a cash working capital analysis of the Company as a
13 whole. Second, the use of the lead/lag study is not biased towards ratepayers or
14 shareholders. In this case RUCO's proposed cash working capital for the Sun City District
15 makes this point clear. RUCO's recommendation would increase the Company's working
16 capital allowance by \$45,368 for the Sun City District. Id. at 14. Finally, many expense
17 payments have identical lags for every utility, i.e. income tax, property tax, and other
18 payroll taxes other than income (i.e. Social Security and Medicare). Therefore, RUCO's
19 adjusted lead/lag study is appropriate and the best indicator of the Company's working
20 capital requirements. The Commission should adopt RUCO's recommended working
21 capital allowance.

22 **RELIEF REQUESTED:** The Commission should approve RUCO's
23 recommendation of \$45,368 for cash working capital for the Sun City Water District.

1 **OPERATING ADJUSTMENTS**

2 **RUCO OPERATING ADJUSTMENT # 5 - PROPERTY TAX EXPENSE**

3 RUCO has consistently advocated an adjustment to property tax expense based
4 on the formula used by the Arizona Department of Revenue ("ADOR"). The evidence
5 shows that the use of the ADOR formula to estimate property taxes is a much more
6 accurate estimate of actual property tax than the methodology that the Company proposes
7 and any of the different methodologies the Commission has recently adopted. The
8 property tax formula, as prescribed in ADOR's memo dated January 3, 2001, values water
9 utilities for property tax purposes by multiplying the average of the water utility's three
10 previous years of reported gross revenues by a factor of two. R-5 at 22.

11 The Commission, however, has repeatedly rejected the ADOR formula. While
12 RUCO believes the ADOR formula is the best methodology for estimating property tax,
13 RUCO is aware that the Commission has been unwilling to accept the ADOR methodology
14 in the absence of additional evidence to support RUCO's conclusion that it is a better
15 estimate of future property tax than the methodology the Commission has approved
16 recently and the Company is recommending here. RUCO is in the process of collecting
17 additional evidence and will present it to the Commission at the appropriate time. In the
18 meantime, RUCO is offering an alternative methodology which is a compromise between
19 what the Commission has accepted and the ADOR methodology. The alternative
20 methodology uses two years of historical gross revenues and one year of RUCO proposed
21 level of revenue. Id. at 23. The Commission has approved this methodology before –
22 Arizona Water Company's Northern Group rate case (Decision No. 64282). Id. The
23 Commission should approve this methodology again as it results in a better estimate of
24 what the Company's future property taxes will be than the Company's proposal.

1 The Company has disregarded the revenues required under the ADOR directive
2 and substituted in its place the adjusted test-year revenues twice, and its proposed level of
3 revenues once ("Company methodology"). Id. at 21. The use of the Company's
4 methodology would allow the Company to over-collect for many years before the actual
5 assessment would catch up to the Company's 2008 projected revenue. Id. at 22

6 **RELIEF REQUESTED:** The Commission should adopt RUCO's property
7 tax methodology which would reduce the Company's property tax expense by (\$25,999)
8 using the ADOR methodology and (\$4,912) using RUCO's alternate methodology.

9
10 **RUCO OPERATING ADJUSTMENT #6 – REVENUE ANUALIZATION**

11 The issue here can be divided into two parts. The first part concerns the issue of
12 whether the Commission should annualize the Company's revenues. The Company did
13 not annualize its revenues in its application because it contends that the Sun City Water
14 District has experienced "virtually no growth." A-7 at 5. It is true that the District
15 experienced little growth, but it did experience some growth and annualization of its
16 revenues is the proper ratemaking procedure. Id. RUCO recommends the Commission
17 annualize the Company's revenues to a year-end customer level as it provides a more
18 accurate accounting of revenue on a going-forward basis.

19 The second part concerns the Company's proposed expense annualization. The
20 Company believes that if the Commission annualizes revenues it is only fair that the
21 Commission annualize its expenses. Transcript at 594. In support of its position, the
22 Company has annualized its expenses. A-7 at 5. RUCO does not take issue with
23 annualizing the Company's expenses. RUCO objects, however, to the Company's
24 resulting adjustment because its calculations are misplaced. The Company recommends

1 an overall annualization adjustment to expenses of \$2,649. Id. However, according to the
2 Company, the revenues the Company will generate from the 30 additional test-year
3 customers is \$1,844. Transcript at 596. In other words, it will cost the Company \$2,649 to
4 generate \$1,844 in revenues. The Company's calculation of its annualized expenses does
5 not make sense when compared to its annualized revenues. The Company offers as an
6 explanation that its customer level is subject to seasonality. Id. Despite the Company's
7 explanation, the Company's expense annualization does not make sense because it
8 implies that the Company would have negative operating income which is not what is
9 reflected in its rate application (see Company Application, Schedule E 6, page 1, line 42
10 attached hereto as Exhibit A).

11 The confusion lies in the Company's calculations of its annualized expenses. For
12 instance, the lion's share of the Company's expense annualization adjustment is
13 attributable to \$2,041 in fuel and power expense. Id. The majority of the Company's 30
14 additional test year customers were residential users. Id. at 597. In calculating the fuel
15 and power expenses for those customers, the Company averaged the annual consumption
16 of not only the residential users but the commercial, irrigation and CAP Water use
17 customers. Id., R-3. RUCO made the same calculation using the average consumption of
18 the $\frac{5}{8}$ and $\frac{3}{4}$ residential customers as they made up the majority of the additional test-
19 year customers. R-7 at 32. RUCO's calculation, using only the average consumption of
20 the residential $\frac{5}{8}$ and $\frac{3}{4}$ users results in a more accurate annualized fuel and purchase
21 expense of \$726. Id. at 31. In total, RUCO's recommended expense annualization is
22 \$1,034. Id. In comparison to the \$1,844 of revenues the Company anticipates from the 30
23 additional test-year customers, RUCO's expense annualization makes sense.

1 **RELIEF REQUESTED:** The Commission should adopt RUCO's
2 recommendation to annualize revenues and also approve RUCO's recommended expense
3 annualization of \$1,034 for a net increase in revenues in the amount of \$810.
4

5 **RUCO OPERATING ADJUSTMENT # 7 – MISCELLANEOUS EXPENSE**

6 The Company has made various changes to its position throughout this proceeding
7 on this issue and is hoping its last-minute final position will be approved. RUCO initially
8 made an adjustment to miscellaneous expense of (\$4,405) that removed expenses related
9 to gifts, flowers, awards, and meals. R-5 at 24-25. These expenses should be paid for by
10 the Company's shareholders, not ratepayers. Id. The Company, in its rebuttal, disagreed
11 with RUCO's miscellaneous adjustment. A-7 at 11-12. The Company witness, Linda
12 Gutowski, states, "We disagree with the disallowance for meals and would add back \$184
13 to RUCO's disallowance of \$4,405." A-7 at 11-12. In its rebuttal schedules, however, the
14 Company had applied RUCO's miscellaneous expense adjustment of (\$4,405). A-7,
Schedule C-2, page 1, column [F], line 20

15 RUCO, in its surrebuttal testimony agreed to add back \$184 to RUCO's (\$4,405)
16 miscellaneous expense adjustment. R-7 at 33, lines 9-11. The Company failed to
17 recognize RUCO's or any miscellaneous expense adjustment in its rejoinder position. A-8.
18 When asked about it at the hearing, Ms. Gutowski testified that she "was sort of hoping
19 you wouldn't notice it." Transcript at 601. Regardless of what the Company was hoping,
20 the Company has failed to provide support for its request to charge ratepayers for gifts,
21 flowers, and awards. These types of expenses are not the responsibility of ratepayers.

22 **RELIEF REQUESTED:** The Commission should adopt RUCO's miscellaneous
23 adjustment to reduce miscellaneous expense by the net amount of, \$4,405 - \$184,
24 (\$4,221).

1 **RUCO OPERATING ADJUSTMENT # 8 – ACHIEVEMENT INCENTIVE PAY (“AIP”)**

2 RUCO’s adjustment to AIP reflects the authorized adjustment accepted in the
3 Company’s recent Paradise Valley Water District rate case in Decision No. 68858. The
4 Commission decision stated the following:

5 RUCO recommends disallowing 30 percent, or \$5,555 of the
6 \$18,517 in Arizona Corporate allocated management fees
7 related to the Company’s Annual Incentive Plan expenses,
8 because 30 percent of the AIP is directly related to Company
9 financial performance measures and 70 percent to operational
and individual performance measures (RUCO Br. at 18).
RUCO argues that the 30 percent portion of AIP expenses
based on financial performance measures benefit only
shareholders (id.)...

10 We agree with RUCO that shareholders are the primary
11 beneficiaries of additional profit the Company achieves as the
12 result of the Company meeting its financial targets, and
13 therefore find RUCO’s proposal to disallow the 30 percent of
the AIP that is based on the Company’s financial performance
measures to be reasonable and appropriate. R-5 at 25.

14 RUCO recommends the same 30 percent disallowance in the present case. The
15 Company argues that the same adjustment is not appropriate in the subject case.
16 Transcript at 407-408. The Company claims that the Sun City Water District is unprofitable
17 unlike the case in the Paradise Valley Water District. Id., A-4 at 18-19. According to the
18 Company, “it is appropriate to reward employees for reducing losses and helping to create
19 a healthier utility which is *only* to the benefit of customers.” A-3 at 19. The Company’s
20 argument lacks merit and should be rejected. First, it is untrue that the Company is not
21 profitable. In the test year and the preceding two years, the Company had a positive net
22 operating income. See Company’s rate application, Schedule E-6 at 1, attached hereto as
23 Exhibit 1. Second, it is irrelevant whether the Sun City Water District is currently operating
24 at a loss or profit. The AIP program is the same incentive program in all of Arizona-

1 American's districts. If some districts were consistently operating at a loss, it is difficult to
2 imagine that the Company would be paying out rewards for not hitting earnings targets in
3 those districts. Moreover, the Company's argument that a financially healthier company
4 only works to the benefit of customers is inaccurate. Shareholders also benefit through a
5 healthier utility in future profits and should bear a portion of the AIP costs as the Company
6 advances towards profitability.

7 **RELIEF REQUESTED:** For Sun City Water the total adjustment is a reduction to
8 AIP management fees of (\$32,230).

9
10 **RUCO OPERATING ADJUSTMENT # 9 – REGULATORY EXPENSE**

11 RUCO and the Company agree on the total amount of rate case expense that the
12 Commission should allow the Company in this case. RUCO, the Company and Staff do
13 not agree on what would be an appropriate period to compute a normalized level of
14 regulatory expense. The Company and Staff believe that four years is proper. Transcript
15 at 830. RUCO believes that three years, which the Company originally requested in its
16 direct case, is appropriate. Id.

17 RUCO is concerned that the Company may seek rate relief before the Company
18 would fully recover its rate case expenses in this case using a four-year amortization
19 period. Id. In response to the question of whether the Company accepts Staff's proposal
20 to amortize regulatory expense over a four year period, Company witness, Thomas
21 Broderick states, Yes but "... if the next rate case is sooner than that, I intend to include
22 any unamortized expense from this current case into rate case expense for the next case."
A-5 at 6.

23 The failure of the Company to recover its full rate case expense prior to filing its
24 next rate case would result in an unamortized balance which the Company intends to seek

1 recovery of in the next rate case. Id. Staff has indicated that it would oppose the
2 "Company's suggestion that it could seek recovery of unamortized rate case expense
3 should it fill (sic) for a rate increase prior to 2012." See Staff's Executive Summary of
4 Alexander Igwe. RUCO would also oppose any attempt to recover the unamortized
5 portion in the next rate case. Transcript at 830-831.

6 In short, allowing a utility to re-amortize prior rate case expense would in essence
7 allow the utility to recover rates that are no longer in effect. Standard and almost
8 universally accepted ratemaking principles prohibit retroactive ratemaking. Also, since the
9 amortization period is an estimate of the length of time rates are expected to be in effect,
10 the time period is not exact and usually results in over or under-recovery. Allowing a utility
11 to re-amortize prior rate case expense in a subsequent docket would be inequitable and
12 unfair to ratepayers. See for example the Direct Testimony of Marylee Diaz Cortez in
Docket No. U-1303-94-182 at 90.

13 **RELIEF REQUESTED:** The Commission should approve RUCO's recommended
14 three year amortization period for regulatory expense.

15
16 **RUCO OPERATING ADJUSTMENT # 12 - MAINTENANCE EXPENSE**

17 The Company in its rebuttal testimony included an adjustment for tank
18 maintenance. A-7 at 16. The Company proposes to amortize the expense over a three-
19 year period at \$40,833 per year. Id. This adjustment was filed late and RUCO did not
20 have adequate time to verify or analyze this adjustment. The Company has provided
21 RUCO with insufficient supporting data to verify this expense.

22 **RELIEF REQUESTED:** The Commission should reject the Company's late filed
23 request to include expense associated with tank maintenance.

1 **RUCO OPERATING ADJUSTMENT # 13 – INCOME TAX EXPENSE**

2 RUCO's disagreement with the Company here is solely a function of the two
3 different operating income levels.

4 **RATE DESIGN**

5 RUCO and the Company are in agreement on rate design with two minor
6 exceptions. First, RUCO believes a slight and gradual shift of revenue from the monthly
7 minimum charge to the commodity rate would be beneficial in creating a stronger price
8 signal to ratepayers. R-6 at 2. RUCO's recommendation would further enhance
9 conservation goals for the Sun City Water District. Id. The second exception RUCO takes
10 with the Company's proposed rate design is the level of recommended increases in
11 revenue the Company proposes. Id.

12 The Commission has frequently expressed its preference for rate designs that have
13 an approximate ratio of sixty percent of revenue derived from commodity rates and forty
14 percent generated through the monthly minimum charge. Id. at 3. A 60:40 ratio promotes
15 conservation and sends a strong-price signal to consumers to conserve. Id. RUCO's rate
16 design was designed with this ratio in mind and moves the Company's proposed rate
17 design closer to the preferable 60:40 ratio.

18 **RELIEF REQUESTED:** The Commission should approve RUCO's proposed rate
19 design.
20

21 **COST OF CAPITAL**

22 The Commission should adopt RUCO's recommended rate of return of 7.36 percent,
23 which is the weighted cost of RUCO's recommended costs of debt and equity capital. R-9
24 at 4.

1 RUCO is recommending a capital structure comprised of 57.7 percent debt and
2 42.3 percent equity⁵. R-9 at 5. The Company is recommending a capital structure
3 comprised of 58.62 percent debt and 41.38 percent equity. Id. at 5-6. By comparison,
4 Staff is recommending a capital structure comprised of 61.50 percent debt and 38.5
5 percent equity. Id. at 5. The main difference between Staff, RUCO and the Company is
6 Staff's decision to include \$25,391,823 in short-term debt of which \$1,000,000 is zero-cost
7 capital associated with the Company's \$3 million interconnection agreement with the City
8 of Phoenix. Id. RUCO and the Company are recommending that the \$3 million associated
9 with the Phoenix Interconnection Agreement be treated as zero-cost capital. Id.

10 The inclusion of short term debt in a company's capital structure is something that
11 should be considered on a case-by-case basis. R-9 at 7. Based on the facts in this case,
12 however, the Commission should not include the short-term debt in the Company's capital
13 structure. The short-term debt issue relates to the Company's plan to finance a Central
14 Arizona Project treatment facility, known as the White Tanks Plant, through the use of
15 hook-up fees. Id at 7-8. In the case of the White Tanks Plant, short-term debt would be
16 paid off by the eventual collection of hook-up fees which will be treated as a source of
17 cost-free capital (i.e. contributions-in-aid-of-construction). Id. For this reason, RUCO does
18 not believe that any interim short-term debt that is directly associated with the White Tanks
19 Plant should be included in the Company's capital structure.

20
21
22
23
24 ⁵ RUCO mistakenly reversed the percentages in its Issue Matrix. RUCO's final recommended capital structure is 57.7 percent debt and 42.3 percent equity.

1 The Company is recommending a cost of equity of 10.89 percent. RUCO is
2 proposing a 9.89 percent cost of equity. R-9 at 4. In arriving at its final cost of equity
3 recommendation, RUCO analyzed a sample of publicly traded water providers and publicly
4 traded natural gas local distribution companies. R-8 at 9. RUCO then averaged the cost
5 of equity estimates of the water and gas companies and arrived at an average DCF
6 estimate of 8.64 percent. R-8 at Schedule WAR-1 at 3. RUCO also considered a sample
7 proxy of both water and gas companies to determine an appropriate range for a cost of
8 common equity using the CAPM method. Id at 35-36. RUCO originally averaged its DCF
9 and CAPM estimates and added 50 basis points to adjust for risk and arrived at a cost of
10 common equity estimate of 10.02 percent. Id. Schedule WAR-1 at 3. During the
11 surrebuttal phase of the proceeding, RUCO's cost of capital witness updated his DCF and
12 CAPM estimates to arrive at RUCO's final 9.89 percent recommended cost of equity. R-9
13 at 10. RUCO's cost of equity recommendation is balanced, fair, well reasoned and results
14 in lower rates than what the Company is recommending for ratepayers.

15 RUCO's recommended cost of common equity is also appropriate given the current
16 environment of historically low inflation and low interest rates in which the Company is
17 operating. R-8 at 47. The Federal Reserve's recent announcements to cut interest rates
18 and Value Line analyst's projection of further interest rate cuts also supports RUCO's
19 recommended cost of equity. R-8 at 45.

20 **RELIEF REQUESTED:** RUCO recommends the Commission adopt RUCO's
21 proposed capital structure of 57.7 percent debt and 42.3 percent equity. RUCO further
22 recommends the Commission adopt its recommended cost of equity of 9.89 percent and
23 weighted average Cost of Capital of 7.36 percent.

1 **CONCLUSION**

2 The Commission should not authorize a rate increase of more than \$1,806,508 for
3 the Sun City Water District. The Commission should deny the Company's proposed
4 FCRM. RUCO recommends the Commission adopt its remaining recommendations to the
5 following:

6 1) Rate base adjustment # 3 - working capital - the Commission should approve
7 RUCO's recommendation of \$40,120 for cash working capital for the Sun City Water
8 District.

9 2) Operating adjustment # 5 - property tax expense - The Commission should
10 adopt RUCO's property tax methodology which would reduce the Company's property tax
11 expense by (\$31,747) using the ADOR methodology and (\$1,600) using RUCO's alternate
12 methodology.

13 3) Operating adjustment # 6 - revenue annualization - The Commission should
14 adopt RUCO's recommendation to annualize revenues and also approve RUCO's
15 recommended expense annualization of \$1,034.

16 4) Operating adjustment # 7 - miscellaneous expense - The Commission
17 should adopt RUCO's miscellaneous adjustment to reduce miscellaneous expense by the
18 net amount of, \$4,405 - \$184, (\$4,221).


19 5) Operating adjustment # 8 - Achievement Incentive Pay - For Sun City Water
20 the total adjustment is a reduction to AIP management fees of (\$32,230).

21 6) Operating adjustment # 9 - regulatory expense - The Commission should
22 approve RUCO's recommended three year amortization period for regulatory expense.

7) Operating adjustment # 12 – maintenance expense - The Commission should reject the Company's late filed request to include expense associated with tank maintenance.

Finally, the Commission should approve RUCO's recommended rate design and Cost of Capital recommendation which includes a RUCO's proposed capital structure of 57.7 percent debt and 42.3 percent equity and a weighted average Cost of Capital recommendation of 7.36 percent.

RESPECTFULLY SUBMITTED this 13th day of February, 2008.


Daniel W. Pozefsky
Attorney

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EXHIBIT A

Arizona American Water Company - Sun City Water
 Test Year Ended December, 2006
 Comparative Departmental Statements of Operating Income

Exhibit
 Schedule E-6
 Page 1
 Witness: Reiker

Line No.		Test Year Ended 12/29/2006	Prior Year Ended 12/9/2005	Prior Year Ended 12/10/2004
1	Water Revenues			
2	Residential	\$ 6,803,255	\$ 6,317,513	\$ 6,059,967
3	Commercial	1,305,547	1,276,640	1,125,458
4	Public Fire	3,784	3,523	2,978
5	Private Fire	20,846	20,840	17,664
6	Miscellaneous	132,827	123,686	129,767
7		<u>\$ 8,266,259</u>	<u>\$ 7,742,202</u>	<u>\$ 7,335,834</u>
8	Other Revenues			
9	Other Revenues	\$ 113,525	\$ 142,058	\$ 145,137
10	Total Operating Revenues	<u>\$ 8,379,784</u>	<u>\$ 7,884,260</u>	<u>\$ 7,480,971</u>
11				
12	Operations Expenses			
13	Source of Supply Expense	1,955,666	1,127,775	743,134
14	Pumping Expense	153,099	(39,918)	223,517
15	Water Treatment Expense	77,482	61,646	60,255
16	Transmission & Distribution Expense	55,034	626,347	1,094,496
17	Customer Accounting Expense	305,808	280,502	258,628
18	Administrative & General Expense	2,044,825	2,887,964	1,840,348
19	Total Operations Expense	<u>4,591,913</u>	<u>4,944,315</u>	<u>4,220,378</u>
20				
21	Maintenance Expenses			
22	Source of Supply Expense	99,499	81,687	48,355
23	Pumping Expense	216,798	132,713	85,463
24	Water Treatment Expense	13,592	12,656	(6,758)
25	Transmission & Distribution Expense	264,664	166,292	167,349
26	Customer Accounting Expense	-	-	-
27	Administrative & General Expense	18,329	10,334	10,667
28	Total Maintenance Expense	<u>612,881</u>	<u>403,682</u>	<u>305,075</u>
29	Total Operations & Maintenance Expense	<u>5,204,794</u>	<u>5,347,997</u>	<u>4,525,454</u>
30				
31	Depreciation Expense	1,556,151	1,689,177	1,480,128
32	Amortization	(32,210)	38,926	35,028
33				
34	Taxes			
35	Property Taxes	166,441	343,778	302,568
36	Other Taxes	89,292	87,512	60,428
37	State Income Taxes	(51,923)	(58,319)	(3,869)
38	Federal Income Taxes	(244,820)	(184,099)	(23,954)
39	Total Taxes	<u>(41,009)</u>	<u>188,871</u>	<u>335,173</u>
40				
41	Total Operating Expenses	<u>\$ 6,687,726</u>	<u>\$ 7,264,970</u>	<u>\$ 6,375,781</u>
42	Operating Income	<u>\$ 1,692,058</u>	<u>\$ 619,289</u>	<u>\$ 1,105,189</u>
43				
44				
45				
46				
47				
48	Supporting Schedules:		Recap Schedules:	
49			E-2	
50	\\Schedules\2007 Sun City Water Sch. A-F.xls\			